## Markets Update  May 27, 2003

All of the asset classes have moved into positive territory for the year as interest rates continue to fall and the economic outlook appears brighter. As the article below discusses, however, there is still a lot of apprehension and fear on the part of many investors. One indicator of this fear is the flow of dollars into bond and “hedge” funds.

### The FEAR & GREED Indexes

**Jeff Troutner, TAM Asset Management, Inc.**

We all know how emotion is exploited in the investment business and right now Wall Street is selling fear—lots of it. The source of today’s fear is the severe decline of growth stocks over the last three years, compounded by constant predictions of low single-digit stock market returns for the future.

For most stockbrokers and far too many fee-based advisors, emotional investors are easy and welcome targets. Products and services are simply created, added, or modified to exploit the emotion of the day. High yielding bond funds, fixed annuities, real estate investment trusts, and the latest fad du jour—hedge funds—are selling like hotcakes.

I’ll save my fawning remarks about hedge funds for another time. For this article, I want to concentrate on investor emotion and how it is translated into what I call the “emotional expected return” that most investors use to make investment decisions and the “financial expected return,” which, sadly, only a relative handful of investment advisors use to manage our clients’ expectations.

To represent an investor’s emotional expected return, I have created the GREED index. GREED stands for the Greatest Return Expectation Emotionally Derived. During stock market tops, the GREED index is very high and during market bottoms, the GREED index is very low. One way to visualize GREED is the chart on the right, which shows the annual stock market returns since 1926. As you can see, high GREED comes and goes.

![GREED Index Chart](chart.png)

To represent the small minority of advisors who refuse to feed on investor emotion and instead focus on the financial expected return and its implication for clients, I have created the FEAR index, or Financial Expectations Attained Rationally. During market tops, the FEAR index is relatively low (future expected returns are lower) and at market bottoms FEAR is high (expected returns are higher).

I do not assign either of these indexes a specific value since I don’t think it’s necessary. The point of this exercise is not to create some fancy market timing strategy to continue on back...
sell to greedy or fearful investors, but to simply point out how investor expectations based on emotion vary so much from what subsequently happens in the real world of market dynamics.

The difference between the emotional GREED index and the rational FEAR index can be seen by examining a few of the more dramatic up and down cycles for the stock market since 1926. The charts below show the Growth of $1 for the S&P 500 index and the subsequent annual 10-year return from each month during the period.

You can see that as stock prices rose up to the Crash of '29 (the left axis and blue line), dollars invested each month grew at a lower rate over the next ten years (right axis, red line). At the peak in September 1929, dollars invested that month lost almost 5% per year for the next ten years. On the other hand, money invested at the bottom in July 1932 compounded at over 12.5% per year for the next ten years. We see the same relationship for the 1970-1974 period shown below. Money invested at the top in December 1972 grew at a rate of about 6.5% for the next ten years, while money invested at the bottom of the cycle grew by over 14% for the next ten years.

Last, but not least, is the current period. The red line shows the next 5-year returns since there are no 10-year data points. I would caution you not to extrapolate this chart to try to compare it to the previous ones. It wouldn’t surprise me if dollars invested at the peak in March 2000 end up with a negative 10-year return, but only time will tell.

The key points I would take from brief look at market trends are:

A. Investors tend to feel the most comfortable and expect the highest future returns after stocks have risen significantly. They should feel just the opposite and rebalance on the way up by selling stocks back to their long-term target and buying short-term bonds up to their targets.

B. When the FEAR index is high (advisor expectations are higher), investors should be buying stocks, again through rebalancing.

C. Investors with all-stock portfolios should maintain a more balanced diversification among large, small, growth, and value stocks and rebalance. In each of these periods, investing equally in each asset class resulted in higher average subsequent 10-year returns, ranging from over 7% more per year for the 1933-1941 period (not shown) to just over 2% per year from 1926-1932. This latter period, which included the worst of the market drop during the Great Depression, was the only period measured that included some 10-year returns that were higher for the S&P 500 index than the balanced mix.

D. As all of the charts show, the following 10-year returns can change pretty dramatically within months of each other. For example, money invested in stocks in March 1931 would have grown by -0.4% per year for the next ten years. Money invested just five months later compounded at almost 6.5% per year. Money invested in July 1932 grew by 12.5% annually, but just two months later new money grew at half that rate for ten years. And money invested in March 1937 would have grown by 4% per year for the next ten years versus almost 12% per year thirteen months later.

Conclusion: Start with a balanced portfolio, stay invested, keep contributing (if possible) and rebalance—especially when the FEAR and GREED indexes are the highest.